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EXPOSURE DRAFT

OMNIBUS PROPOSAL OF PROFESSIONAL ETHICS DIVISION INTERPRETATIONS AND RULINGS

PROPOSED ETHICS RULING NO. 112 UNDER RULE 102: *Use of a Third-Party Service Provider to Assist a Member in Providing Professional Services* □ PROPOSED ETHICS RULING NO. 12 UNDER RULES 201 AND 202: *Applicability of General and Technical Standards When Using a Third-Party Service Provider* □ PROPOSED REVISION OF ETHICS RULING NO. 1 UNDER RULE 301: *Use of a Third-Party Service Provider to Provide Professional Services to Clients or Administrative Support Services to the Member* ~~Computer Processing of Clients' Returns~~ □ PROPOSED DELETION OF ETHICS RULING NO. 5 UNDER RULE 301: ~~Records Retention Agency~~

August 9, 2004

Prepared by the AICPA Professional Ethics Executive Committee for comments from persons interested in independence, behavioral, and technical standards matters.

Comments should be received by October 8, 2004, and addressed to
Lisa A. Snyder, Director, Professional Ethics Division,
AICPA, Harborside Financial Center, 201 Plaza Three,
Jersey City, NJ 07311-3881 or via the Internet at lsnyder@aicpa.org.

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August 9, 2004

This exposure draft contains a number of important proposals for review and comment by the AICPA's membership and other interested parties regarding pronouncements for possible adoption by the Professional Ethics Executive Committee (the "PEEC" or "committee"). The text and an explanation of each proposed pronouncement are included in this exposure draft.

After the exposure period is concluded and the committee has evaluated the comments, the committee may decide to publish one or more of the proposed pronouncements. Once published, the pronouncements become effective on the last day of the month in which they are published in the *Journal of Accountancy*, except as may otherwise be stated in the pronouncements.

Your comments are an important part of the standard-setting process. Please take this opportunity to comment. Responses must be received at the AICPA by October 8, 2004. All written replies to this exposure draft will become part of the public record of the AICPA and will be available for inspection at the office of the AICPA after November 8, 2004, for a period of one year.

All comments received will be considered by the committee at an open meeting, which is scheduled for October 28-29, 2004, to be held in Orlando, Florida.

Please send comments to Lisa A. Snyder, Director, AICPA Professional Ethics Division, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881 or lsnyder@aicpa.org. Comments submitted via electronic mail are encouraged and would be appreciated.

Sincerely,

Bruce P. Webb
Chair
AICPA Professional Ethics
Executive Committee

Lisa A. Snyder
Director
AICPA Professional
Ethics Division

INTRODUCTION AND BACKGROUND

As a result of recent discussion and debate by members of Congress, the media, and state and federal regulators about the responsibilities of businesses to disclose to their customers and clients when they outsource services or production to other countries, the PEEC began a project to assess whether or not the AICPA Code of Professional Conduct (the “Code”) sufficiently addresses our members’ obligations when outsourcing services to third-party service providers.

While Rule 301 – *Confidential Client Information*, of the AICPA Code prohibits the release of confidential client information without the specific consent of the client, Ethics Ruling No. 1, “Computer Processing of Clients’ Returns,” under rule 301 indicates that no violation of the confidential relationship between the member and client occurs when client information is sent to a third-party service provider, provided the member takes all necessary precautions to be sure that the use of the outside service provider does not result in the release of confidential information. Furthermore, Ethics Ruling No. 5, “Records Retention Agency,” under rule 301 would not prohibit a member’s use of a records retention agency to store client records, working papers, and so forth; however, the member is held responsible for preserving the confidentiality of the information.

The Code also requires that a member providing professional services must ensure that the work has been adequately planned and supervised, that sufficient relevant data has been obtained to support the work, and that the service provider complied with all applicable technical and ethical standards. Although not specifically stated in the Code, the member is responsible for the work of any third-party service provider.

The Code, however, does not require disclosure to the client when a third-party service provider is used – whether domestically or overseas.

In determining whether the Code was sufficient or needed to be amended, the PEEC considered a number of ethical issues concerning the use of third-party service providers, including whether:

- Ethics Ruling No. 1, “Computer Processing of Clients’ Returns,” under Rule 301 – *Confidential Client Information* should be revised to encompass the use of third-party service providers in providing *any* professional or administrative support services to clients;
- A new ethics ruling under Rule 201 – *General Standards* and Rule 202 – *Compliance With Standards* should be issued to specifically state that the member is responsible for all work performed by the third-party service provider and that the use of a third-party service provider does not in any way excuse the member from complying with the requirements set forth under these rules;
- A new ethics ruling under Rule 102 – *Integrity and Objectivity* should be issued to require that, prior to disclosing confidential client information to a third-party service provider, a member should inform the client that he or she plans to use a third-party service provider in providing professional services to the client;

- Any additional provisions should be required when the third-party service provider is operating outside of the United States.

The committee deliberated these issues at its January, May, and July 2004 meetings and voted at its July 2004 meeting to expose the proposed rules for comment. While the explanation section preceding each proposal provides further understanding of the committee's rationale and intent, the following positions of the committee should also be considered:

- Although the media and representatives of our federal and state governments have focused on the issue of "offshoring," the committee believes that guidance concerning the use of third-party service providers should apply equally to service providers located domestically and abroad.
- A "third-party service provider" is considered to be any entity that the member, *individually or collectively with his or her firm or with members of his or her firm*, cannot control (as defined by accounting principles generally accepted in the United States), or any individual not employed by the member or the member's firm. Accordingly, other offices of the member's firm or subsidiaries controlled by the firm would not be considered to be third-party service providers. The proposals would apply, however, to affiliated entities that the member or the member's firm does not control, as well as to individuals contracted by the member or member's firm.
- The proposed ethics rulings under rules 102, 201, and 202 apply to the use of third-party service providers in performing *professional services* to clients. The requirements would not extend to service providers used solely for the purpose of providing administrative support services to the member, such as record storage or software application hosting services.
- Professional services would include those services normally considered to be the practice of public accounting such as bookkeeping, tax return preparation, consulting, and attest services, *including related clerical and data entry functions*. For example, the proposed ethics rulings would apply where a member uses an outside firm to perform a physical inventory observation or input client tax return information for the member, or uses a specialist engaged by the member. The committee believes that a third-party service provider that has an active role in the preparation of the work product is providing a professional service, regardless of whether the services provided require professional judgment or are ministerial in nature.
- The committee believes the primary issues of concern regarding the use of third-party service providers are the release of confidential client information, and the client's expectation that when engaging a member to provide professional services, those services will be provided by the member, or partners or employees of the member's firm. The committee has long held the position that the use of third-party service providers for the processing of client tax returns would not constitute a release of confidential client information, but that the member should take reasonable precautions to ensure that the

use of the service provider does not result in the release of confidential information (see current Ethics Ruling No. 1 under rule 301). Because a member remains responsible if confidential client information is disclosed by the service provider without the client's consent, the committee is proposing that the member enter into a contractual agreement with the third party to maintain the confidentiality of the client's information.

- The committee remains committed to the belief that disclosing confidential client information to third-party service providers used in providing a professional service to clients would not constitute a release of confidential client information, and thus not require specific client consent. The committee does however believe that a client has a right to know, and the profession an obligation to be honest and candid with a client, if the client's confidential information may be shared with an entity that is not under the member's or his or her firm's control, or with an individual not employed by the member or member's firm. Accordingly, the committee is proposing a requirement that a member disclose the use of third-party service providers utilized in the provision of professional services to clients.

PROPOSED ETHICS RULING NO. 112 UNDER RULE 102

[Explanation]

The Professional Ethics Executive Committee is proposing a new ethics ruling under Rule 102 – *Integrity and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 102.01), which would require that a member inform the client that he or she may be using a third-party service provider prior to sharing confidential client information with the service provider.

The committee believes that when a client hires a member or his or her firm to perform professional services, the expectation is that the services will be performed by the member or partners or employees of the firm. Accordingly, if the member intends to use the services of a third-party service provider, the client should be informed and be given the opportunity to ask questions concerning the use of the service provider. This is consistent with the principle of Integrity as set forth in *Article III – Integrity* (AICPA, *Professional Standards*, vol. 2, ET sec. 54), which requires a member to be honest and candid.

The committee also believes that the form of disclosure should be left to the member's discretion. For example, the member may choose to include broad language informing the client that a third-party service provider may be used in providing professional services to the client in an engagement letter, in a tax organizer, in the disclosure required under the Gramm Leach Bliley Act, or in a separate disclosure statement. On the other hand, the member may choose to provide the client with specific detail as to the identity of the individual or entity that will be used in providing services to the client as well as the specific services that they will perform. In any case, if the client were to further inquire about the use of the third-party service provider, the member should be candid and forthcoming, and in cases where the client objects to the use of the service provider, the member should provide the professional services without using the third-party service provider or decline the engagement.

**PROPOSED ETHICS RULING NO. 112 UNDER RULE 102 –
*Integrity and Objectivity***

[Text of Proposed Ethics Ruling No. 112]

Use of a Third-Party Service Provider to Assist a Member in Providing Professional Services

Question — A member in public practice uses an entity that the member, individually or collectively with his or her firm or with members of his or her firm, does not control (as defined by accounting principles generally accepted in the United States) or an individual not employed by the member (a "third-party service provider") to assist the member in providing professional services (for example, bookkeeping, tax return preparation, consulting, or attest services, including related clerical and data entry functions) to clients. Does rule 102 require the member to disclose the use of the third-party service provider to the client?

Answer— Yes. The concept of integrity set forth in Rule 102 - Integrity and Objectivity [ET section 102.01] and Article III - Integrity [ET Section 54] requires a member to be honest and candid. Clients might not have an expectation that a member would use a third-party service provider to assist the member in providing the professional services. Accordingly, prior to disclosing confidential client information to a third-party service provider, a member should inform the client that he or she plans to use a third-party service provider. This disclosure does not relieve the member from his or her obligations under ethics ruling No. 1 [ET section 391.001-.002] under Rule 301 – Confidential Client Information [ET section 301.01]. If the client objects to the member's use of a third-party service provider, the member should provide the professional services without using the third-party service provider or the member should decline the engagement.

A member is not required to inform the client when he or she uses a third-party service provider to provide administrative support services (for example, record storage or software application hosting services) to the member.

See ethics ruling No. 12 under Rules 201 – General Standards and 202 – Compliance With Standards [ET section 291.023-.024] and ethics ruling No. 1 under Rule 301 – Confidential Client Information [ET section 391.001-.002] for additional responsibilities of the member when using a third-party service provider.

PROPOSED ETHICS RULING NO. 12 UNDER RULES 201 AND 202

[Explanation]

The Professional Ethics Executive Committee is proposing a new ethics ruling under Rule 201 – *General Standards* and Rule 202 – *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET secs. 201 and 202).

The proposed ethics ruling is intended to clarify the application of rules 201 and 202 to members who use a third-party service provider in providing professional services to clients. The ethics ruling makes clear the committee's position that the member is responsible for all work performed by the service provider. Specifically, the member is responsible for the adequate oversight of all services performed by the third-party service provider and for ensuring that all professional services are performed with professional competence and due professional care. In addition, the member must adequately plan and supervise the professional services provided by the service provider, obtain sufficient relevant data to support the work product and comply with all technical standards applicable to the professional services.

PROPOSED ETHICS RULING NO. 12 UNDER RULE 201 – *General Standards* and RULE 202 – *Compliance With Standards*

[Text of Proposed Ethics Ruling No. 12]

Applicability of General and Technical Standards When Using a Third-Party Service Provider

Question—What responsibility does a member in public practice have for complying with the general and technical standards under rules 201 [ET Section 201 – General Standards] and 202 [ET Section 202 – Compliance With Standards] when using an entity that the member, individually or collectively with his or her firm or with members of his or her firm, does not control (as defined by accounting principles generally accepted in the United States), or an individual not employed by the member (a “third-party service provider”) to assist the member in providing professional services (for example, bookkeeping, tax return preparation, consulting, or attest services, including related clerical and data entry functions) to clients?

Answer—Using a third-party service provider to assist the member in providing professional services to clients does not in any way relieve the member from his or her responsibilities to comply with the requirements of rules 201 and 202. Accordingly, the member remains responsible for the adequate oversight of all services performed by the third-party service provider and for ensuring that all professional services are performed with professional competence and due professional care. In addition, the member must adequately plan and supervise the professional services (as required by applicable professional standards) provided by the third-party service provider, obtain sufficient relevant data to support the work product and comply with all technical standards applicable to the professional services.

See ethics ruling No. 112 under Rule 102 – Integrity and Objectivity [ET section 191.224-.225] and ethics ruling No. 1 under Rule 301 – Confidential Client Information [ET section 391.001-.002] for additional responsibilities of the member when using a third-party service provider.

PROPOSED REVISION OF ETHICS RULING NO. 1 UNDER RULE 301

[Explanation]

The Professional Ethics Executive Committee is proposing a revision to AICPA Ethics Ruling No. 1, “Computer Processing of Clients’ Returns” of ET section 391, *Ethics Rulings on Responsibilities to Clients* (AICPA, *Professional Standards*, vol. 2, ET sec. 391.001-.002), which would update and broaden the application of the ethics ruling beyond that of an outside tax service bureau and make it applicable to any third-party service provider used by the member.

The revised ethics ruling also clarifies that disclosing confidential client information to a third-party service provider for the purpose of providing professional services to clients or for administrative support purposes would not be in violation of Rule 301 – *Confidential Client Information*, and therefore, the specific consent of the client is not required. However, the proposed ethics ruling under rule 102 (see page 8 of this exposure draft) would require that the client be informed where a third-party service provider is being used to provide professional services to the client. In addition, a member remains responsible under rule 301 if confidential client information is disclosed by the service provider without the client’s consent. Accordingly, the proposed revision contains a provision which would require the member to enter into a contractual agreement with the third-party service provider to maintain the confidentiality of the client’s information, and require that the member use reasonable care in determining that the third-party service provider has appropriate procedures in place to prevent the unauthorized release of confidential client information. For example, the member should discuss with the service provider the specific controls in place to ensure that the client’s information remains confidential and the member should be satisfied that reasonable efforts are undertaken to assure the confidentiality of the client’s information. If the member is unable to obtain a contractual confidentiality agreement with the third-party service provider, specific client consent would be required prior to the member disclosing confidential client information to the service provider. These requirements apply to third-party service providers used in providing professional services as well as to those used for the purpose of providing administrative support services.

PROPOSED REVISION TO ETHICS RULING NO. 1 UNDER RULE 301 –

Confidential Client Information

[Text of Proposed Revisions to Ethics Ruling No. 1]

[Added text is in *italics*; deleted text is ~~struck through~~.]

1. ~~Computer Processing of Clients' Returns~~ *Use of a Third-Party Service Provider to Provide Professional Services to Clients or Administrative Support Services to the Member*

.001 *Question—* ~~May a member make use of an outside service bureau for the processing of clients' tax returns? The member's firm would control the input of information and the computer service would perform the mathematical computations and print the return. Is there any violation of the confidential relationship in the fact that client information leaves the member's office?~~

A member in public practice uses an entity that the member, individually or collectively with his or her firm or with members of his or her firm, does not control (as defined by accounting principles generally accepted in the United States), or an individual not employed by the member (a "third-party service provider") to assist the member in providing professional services (for example, bookkeeping, tax return preparation, consulting, or attest services, including related clerical and data entry functions) to clients or for providing administrative support services to the member (for example, record storage or software application hosting services). Does rule 301 require the member to obtain the client's consent prior to disclosing confidential client information to the third-party service provider?

.002 *Answer—* ~~A member may utilize outside services to process tax returns. He must take all necessary precautions to be sure that the use of outside services does not result in the release of confidential information.~~

No. Rule 301 is not intended to prohibit a member in public practice from disclosing confidential client information to a third-party service provider used by the member for purposes of providing professional services to clients or for administrative support purposes. However, prior to using such a service provider, the member should enter into a contractual agreement with the third-party service provider to maintain the confidentiality of the information and use reasonable care in determining that the third-party service provider has appropriate procedures in place to prevent the unauthorized release of confidential information to others.

In the event the member does not enter into a confidentiality agreement with the third-party service provider, specific client consent should be obtained prior to the member disclosing confidential client information to the third-party service provider.

See ethics ruling No. 112 under Rule 102 – Integrity and Objectivity [ET section 191.224-.225] and ethics ruling No. 12 under Rules 201–General Standards and 202 - Compliance With Standards [ET section 291.023-.024] for additional responsibilities of the member when using a third-party service provider.

PROPOSED DELETION OF ETHICS RULING NO. 5 UNDER RULE 301

[*Explanation*]

The Professional Ethics Executive Committee is proposing a deletion of Ethics Ruling No. 5, “Records Retention Agency,” of ET section 391, *Ethics Rulings on Responsibilities to Clients* (AICPA, *Professional Standards*, vol. 2, ET sec. 391.009-.010) because the substance of this ethics ruling has been incorporated into the proposed revised Ethics Ruling No. 1, “Use of a Third-Party Service Provider to Provide Professional Services to Clients or Administrative Support Services to the Member” (see pages 12-13 of this exposure draft).

[*Text of Proposed Deletion of Ethics Ruling No. 5*]

~~5. — Records Retention Agency~~

~~.009 — *Question* — May a member use a records retention agency to store his clients' records, working papers, and so forth?~~

~~.010 — *Answer* — There is no objection to the use of such a records center. However, responsibility for preserving the confidential nature of the records rests with the member.~~